Centre for Financial Market Integrity
CFA INSTITUTE

MEMO

TO	Gary Gensler
CC	Kurt Schacht, CFA James C. Allen, CFA
FROM	Jeffrey J. Diermeier, CFA
DATE	9 December 2008
RE	Thoughts on Financial Regulation

Thank you for contacting us on behalf of the Obama-Biden Presidential Transition Team to solicit our views on the SEC and the major issues it faces. We appreciate the opportunity to suggest changes to the mandate of the Securities and Exchange Commission, as well as to provide our views about financial market regulation in general.

While there is a general recognition that regulatory reforms are needed, we also are aware that historically changes that have been made in a crisis have not necessarily benefitted the markets or investing public over time. Therefore, as a threshold issue, we urge that any changes in the mandate or structure of the SEC be made cautiously and with great deliberation.

Here is our list of the most important issues the SEC needs to address:

- **Investor Input —** We believe that whatever proposals are considered and adopted for regulatory reform will benefit significantly from investor input. The CFA Institute Centre for Financial Market Integrity and the Council of Institutional Investors will soon announce the formation of an Investors Working Group of high-level market professionals, industry leaders, academics and lawyers to study and comment on specific reforms that are needed to safeguard investor interests. We offer the assistance of this group as you consider various recommendations to this new Administration.

  Longer-term, we firmly believe that continuous investor input is essential to the success of the SEC's mission. While the public comment period on formal proposals provides one avenue of input, we encourage creation of a more formalized vehicle to provide SEC staff with an investor viewpoint early in the process of SEC consideration of proposals, concept releases and interpretative guidance. This structure should allow for regular meetings between staff and investors and be aided by mechanisms for investors to voice concerns on an ongoing basis. A similar call for investor input in the standard-setting process of financial reporting was recently issued by the Advisory Committee on Improvements to Financial Reporting, on which I participated, in its 2008 Report to the SEC.

- **Corporate Governance Issues** — Two issues in particular have been on the SEC's agenda for many months without further action. Shareholder access is one such issue that the Commission has vowed, but failed, to address. If investors are to hold boards of directors and management accountable for their decisions and performance at a reasonable cost to such investors, some rational level of access to the proxy statement is required. The other matter delayed by the Commission for many months now relates to confirming the NYSE recommendation to limit broker non-votes in director elections. The Commission should invoke this recommendation promptly so that it will apply for the 2009 proxy season.

- **Transparency and Standardization of Certain Large Over-the-Counter Derivatives Markets —** Firms and investors are concerned that certain investors manipulate the price of credit default protection and other derivatives prevalent in the on going financial crisis. In addition, there is little or no price discovery in many of these institutional markets, contributing to huge illiquidity and forced write-down of assets on the balance sheet.

  Many have called upon regulators to work with industry groups to achieve improved transparency and standardization of certain large over-the-counter derivatives markets such as the CDS market. These efforts would include supporting standardization of terms, and fostering and supporting the formation of a central clearing function for frequently traded instruments. They also should include mandated standardization of identification systems for derivative and cash instruments of a specific issuer. This will help ensure trading abuses impacting such issuer can be monitored across different markets to help uncover, prosecute, and reduce market abuse.

- **Oversight of Hedge Funds** — The SEC should task the hedge fund industry to work with investors in creating a formal and workable self-regulatory code of conduct for the sector. Several industry efforts have fallen short in this regard, opting instead for a cacophony of "pick-and choose" best practices. The industry should apply a consistent and verifiable code or face formal regulation, in our view.

- **Short Selling** – Short selling has been wrongly blamed and suspended as a contributing factor in the ongoing financial crisis. Any further actions in this regard should be refrained from and attention given to better enforcement of existing naked short selling rules and possible re-implementation of the up-tick rule. Short selling is important to markets for a number of reasons relating to market efficiency, price discovery, and liquidity. Specifically, the up-tick rule was eliminated in recent years believing it provided little investor protection during normal market circumstances. Many market participants believe it would have assisted greatly in the current turmoil, mitigating the need to suspend short selling for an entire market sector.

- **New SEC Chair or Market Regulator Chair** — The new chair of the SEC or any successor agency as has been suggested in various regulatory "blue prints", should have a demonstrated experience and commitment to investor protection through prior work, commentary and writings. A chair with market experience and leadership qualities to guide the current or reformulated SEC through the important regulatory changes that will result from the crisis and the need to modernize our system will be a critical nomination for the new Administration.

- **Independence of Financial Reporting Standard Setter**

We are concerned that political agendas and other influences have appeared to dilute the integrity of certain standard-setting functions of the SEC and the FASB. While uncompromised independence is essential in all aspects of the SEC's rulemaking and standard-setting, we particularly urge the shoring up of its financial reporting standard-setting processes in order to ensure complete independence of decision-making.

- **Credit Rating Agencies (NRSROs)** — We assume that most of the work needed to tighten oversight for NRSROs has already been done or currently in process. We support these efforts.

- **Regulatory Reform and Structure** — We believe that discussions about the issues facing the SEC cannot be separated from a larger discussion about overall regulatory architecture in the United States. Much discussion, with investor input, is needed on how financial market regulation should be reorganized.

  Under the current regulatory system, financial firms, whether regulated or unregulated, were able to engage in many activities and invest in regulated and unregulated instruments. In many cases, these activities were outside the regulatory oversight of their primary regulators. Several have suggested a new Safety and Soundness Regulator ("SSR") be created to oversee all financial institutions. This would include banks, thrifts, insurers, investment funds, market clearing, and centralized oversight of counterparties etc., to ensure a comprehensive and coordinated view of the "systemic health" of the system. We are uncomfortable with the suggestion that such SSR should be the Federal Reserve Board. The role of SSR could easily conflict with the Fed's principal roles of protecting the value of the dollar and managing the supply and cost of funds in the financial system.

  The second piece of this new architecture contemplates a "super" SEC to concentrate its focus on market regulation, including oversight of market abuse, investor protections (including '34 Act reporting requirements; continued oversight of accounting standards setting; Investment Company and Advisers Acts protections; etc.), and the fair and efficient operation of securities markets. It should have authority to monitor and oversee transactions across different regulated markets to prevent market participants from engaging in market abuse in one market to benefit activities in another. Any such super regulator would perform this role more efficiently by rationalizing and possibly merging many of the functions now spread among numerous federal agencies and the current network of self regulatory organizations.

  One additional component of any new regulatory structure should consider how to best establish a proactive "systemic-risk" management function within the new framework. This would focus on identifying and addressing emerging areas that threaten market stability. This function would likely require a system of data and information gathering and analysis in order to observe what products and instruments are growing rapidly and which pose the potential for systemic risk. The importance of this risk management feature is something deserving of prompt attention, whether this function ultimately resides within the jurisdiction of the SEC or a new SSR.

  We strongly support this discussion and agree with the need to revamp an overly complex, disjointed and often inefficient regulatory framework in the U.S.

- **Balance Effective Oversight and Market Innovation** — One of the competitive advantages of U.S. financial markets has historically been their ability to **create** new products and solutions to serve investor needs, reduce issuer risks, and enhance market efficiencies. Regulatory reforms should seek to balance the need for better prudential oversight without restricting or eliminating innovation in the markets.

Finally, as you may be aware, I am leaving my position as President and CEO of CFA Institute at the end of this year. To ensure continued communications, therefore, I want to introduce you to members of the CFA Centre staff, Kurt Schacht CFA, and James Allen, CFA. Their contact information appears below. I suggest that they join us in our call.

Kurt N. Schacht JD, CFA
Managing Director
CFA Institute Centre for Financial Market Integrity
1 212 756 7728
Kurt.schacht@cfainstitute.org

James C. Allen, CFA
Director-Capital Markets
CFA Institute Centre for Financial Market Integrity
1 434 951 5558
James.allen@cfainstitute.org